



ASSURANCE AND ADVISORY
BUSINESS SERVICES

September 2002

 **ERNST & YOUNG**

FROM THOUGHT TO FINISH.™

Management Report

Democratic Republic of Timor-Leste

Year Ended 30 June 2002

**DEMOCRATIC REPUBLIC OF TIMOR-LESTE
MANAGEMENT LETTER
30 JUNE 2002**



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INTRODUCTION

We have completed our audit of The Government of the Democratic Republic of Timor-Leste for the financial year ended 30 June 2002 and have issued a qualified audit report. The reason for the audit qualification is explained below.

Our audit has been conducted in accordance with International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. Our procedures included examination, on a test basis, of evidence supporting the amounts and other disclosures in the financial statements. Our audit also includes assessment of the accounting principles used and the significant accounting estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

EXECUTIVE SUMMARY

Audit Report

The audit report is qualified as follows:

We have noted a number of deficiencies in the Power Invoicing Management System "PIMS" utilised by the Power Authority of the Government of the Democratic Republic of Timor-Leste. The "PIMS" system is used to calculate Power Service charges for Timor-Leste, due to the deficiencies in the system we are unable to determine whether the amounts invoiced for Power Service charges are accurate and reliable. Our audit relating to Power service charges has been limited to ensuring that the amounts banked for Power service charges were properly recorded in the accounts. Accordingly, we are unable to express an opinion on whether power service receipts amounting to \$1,997,483 represent the full amount that should otherwise have been received and we cannot determine the effects of such adjustments, if any, as might have been determined to be necessary had this limitation not existed.

Key Audit Findings

Our examination for the year ended 30 June 2002 disclosed a number of other matters, which are appropriate to be brought to your attention, these are included in the accompanying report.



Audit Findings (Continued)

The key items highlighted during our audit are as follows:

1. Accrual Accounting (Schedule 1)

The financial statements are prepared on a cash basis and modified cash basis. By adopting the cash basis of reporting, the Government only records receipts when they are banked. In addition, the revenue retention agencies do not record the details of the full amount of revenue to be collected each year. Currently, the balance sheet prepared by the Government only records cash assets, investments, accounts payable and equity. No other assets and liabilities of the Government are recorded, for example fixed assets, hence the financial statements only provide a partial view of the Government's financial position.

2. Power Authority (Schedule 2)

A number of serious deficiencies in the Power Invoicing Management System (PIMS) was noted. Due to the serious nature of these deficiencies, we have been unable to determine whether the charges calculated for power service are accurate and reliable. (refer to audit qualification)

3. Asset Register (Schedule 3)

The full listing of assets has not been completed and no complete physical verification of the assets of the Government was undertaken during the year.

4. Revenue Retention Agencies (Schedule 4)

Revenue retention agencies are not preparing accrual financial statements and are not being separately audited.

Please refer to the attached schedules for further details and other findings.

We acknowledge that the Democratic Republic of Timor-Leste has been a recently formed government and is still in the formulation process of policies and procedures. We further understand that this is a significant task for the new government especially in light of the reduction of international staff assistance and we acknowledge that improvements in procedures and policies are taking place. In order to expedite improvements we would recommend that most government staff, particularly local staff, be provided with training to enable them to carry out their tasks effectively, efficiently and in compliance with regulation requirements.



MATTERS ARISING

The following schedules set out further details of issues arising from our audit. A number of the issues identified were also raised in the prior year. We have colour coded our priority ratings to enable major weaknesses to be easily identifiable. The key to the colour ratings is listed below the matters arising.

Schedule	Audit Issue	Rating	Issue Raised in Prior Year
1	Financial Statements		√
2	Power Authority		
	2.1 Integrity of PIMS system		
	2.2 Power Meters		
	2.3 Power Debt Collection		
	2.4 Power Billing		
3	Asset Register		√
4	Revenue Retention Agencies		
5	Interest Revenue Timor Gap Royalties		
6	Revenue Reconciliation		
7	Insurance		√
8	Procurement		
9	Payroll		
10	Unallocated Stock		
11	Bank Reconciliations		
12	Bilateral Fund Agreements		√
13	Internal Audit Function and Strategic Audit Plan		√
14	Land and Property Debtors		√
15	Business Continuity Plan		√

Ratings



A major weakness that you must address soon.



An important matter that will significantly improve the control environment, the accounting system or the operations of the business.



A minor weakness that you should nevertheless address to improve the control environment, the accounting system or the operations of the business.

DEMOCRATIC REPUBLIC OF TIMOR-LESTE
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GENERAL

The comments above made do not imply any lack of integrity or honesty on the part of the management committee and employees of the government. We have received comments on our management letter from the management and they are incorporated in this report.

As part of our examination, we made a study and evaluation of the Central Fiscal Authority's system of internal control to establish the level of our reliance on the system in determining the nature, timing and extent of other auditing procedures necessary to enable us to express our audit opinion. Our audit was not extended to the Agencies systems of internal controls, but rather concentrated on Central Fiscal Authority systems and controls. This work is not primarily directed towards the discovery of weaknesses or the detection of fraud or other irregularities and should not, therefore, be taken to assure that no other weaknesses exist. Accordingly, the comments in this letter refer only to those matters, which have come to our attention during the course of our normal audit work and do not attempt to indicate all possible improvements, which a special review might develop.

We wish to take this opportunity to thank you and your staff for the assistance given to us during the course of our audit.



DETAILED SCHEDULES

1. Financial Statements

Audit Issue

Financial Statements of the Democratic Republic of Timor-Leste are prepared on a cash basis and modified cash basis.

Observation and Effect

The government currently prepares its financial statements on a cash basis, in accordance with Regulation 2001/13 and on the modified cash basis under the transitional provisions of the International Public Sector Accounting Standards "IPSAS".

We noted during our audit deficiencies in the revenue reconciliation processes, in particular the reports produced by the Power Authority could not be relied upon. By adopting the cash basis of reporting, the Government only records receipts when they are banked. No debtors are recorded in the financial report, furthermore our audit found that debt collection policies for revenue retention agencies have not been formulated or followed up on. This may lead to the non-collection of monies due to the Government. Currently the balance sheet prepared by the Government only records cash assets, investments, accounts payable and equity. No other assets and liabilities of the Government are recorded, for example fixed assets, hence the financial statements only provide a partial view of the Government's financial position.

Recommendation

The government should establish a time frame to adopt full accrual accounting in accordance with International Public Sector Accounting Standards. Accrual accounting will assist the government in obtaining better financial information and accountability, which would in time enhance the decision-making capabilities and resource allocations.

We further recommend that debt collection procedures and policies are formulated for all government revenue.

(Rating ■■■)



1. Financial Statements (Continued)

Management response

We agree that adopting a full accrual accounting provides better information for decision-making and economic and financial evaluations. International Public Sector Accounting Standards do provide for preparation of accounts on the accrual basis. However, there is a transitional provision for preparing accounts on the 'cash basis' and this will become a Standard by end of this calendar year.

For the government of Timor-Leste's accounts, we have adopted both the cash basis and the modified cash basis of reporting. The cash basis, as you are aware reports transactions only when cash is received or cash is paid out. The modified cash basis on the other hand recognises transactions in the accounting year when revenue is actually received but recognises expenditure against the budget when a commitment is raised notwithstanding cash payments having not been done during the same reference period. The rationale of adopting, as supplementary information, the modified cash basis of reporting is to ensure that expenditures relating to a budget year are recognised in the year in which a budget for the expenditure was approved. For example, if a budget under goods and services was approved in the sum of \$1 million for a particular department in year 1, the expenditures against that year's budget should be recognised as long as a commitment has been raised before the end of that fiscal year. This is a prudent way of ensuring that the commitment can be paid even in the ensuing fiscal year against the preceding year's budget especially where the same department does not have a fresh appropriation to cater for the particular expenditure in the ensuing year's budget. In as much as the full accrual basis is a more informative basis for financial decision-making, most governments in the world currently use a combination of cash and modified cash basis of reporting. Timor-Leste will graduate, overtime, from the current basis but you would agree that in a capacity building environment, the migration to full accrual basis must be systematically planned, programmed, and gradually introduced to avoid major mishaps in reporting.

Audit Conclusion

We agree with your comments that the adoption of accrual accounting should be planned and gradually incorporated.



2. Power Authority

Summary Audit Issues

The following points relate to the Power Authority. During our audit we noted a number of serious deficiencies in the Power Invoicing Management System (PIMS), these deficiencies are detailed in the schedules below.

Due to the serious nature of these deficiencies, we have been unable to determine whether the charges calculated for power service are accurate and reliable. This has resulted in a qualification on our audit report.

2.1 Integrity of Power Invoicing Management System (PIMS)

Audit issue

The total billing for power charges amounting to US\$18,784,111 calculated by PIMS cannot be relied upon.

Observation and Effect

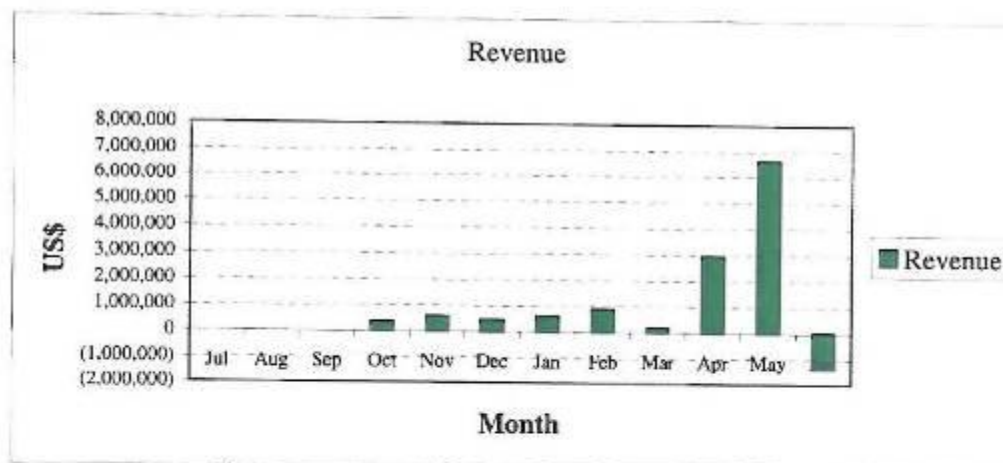
The billing report generated from the PIMS does not appear to be reliable, due to the following:

- inaccurate meter readings as discussed in point 2.3;
- inaccurate calculation of domestic power charges as discussed further in point 2.4;
- meter reads are manually input into PIMS, during our audit we found numerous errors in which the meter read did not agree to what was entered into PIMS;
- PIMS does not produce exception reports which would highlight large or unusual meter reads, furthermore no manual review of meter reads is undertaken to ensure input into PIMS is reasonable; and
- it was noted during our audit that some meter readings were producing negative reads from month to month and that the PIMS system is not able to identify negative power usage. For example, if the meter read in May is 1000 kw and the meter read in June is recorded as 800 kw, PIMS will calculate the power charge as 200 kw for the month of June.



2.1 Integrity of Power Invoicing Management System (PIMS)(continued)

The chart below shows the power charges calculated by PIMS on a month-by-month basis. As can be seen there are large variances particularly from March to June, with June actually recording a negative read for the month.
(source ADB Summary Report)



Due to the problems above we are not able to determine the exact extent of the inconsistencies within the billing records of PIMS, nor are we able to quantify the errors. It is not possible to determine whether the government is collecting all the power revenue that it is entitled to.

Recommendation

We acknowledge that you are aware of the problems associated with the Power Authority. We strongly recommend a complete review of the PIMS system be undertaken to ensure that the parameters of the system can enable the calculation of accurate information. Particularly we would recommend that the report writer within PIMS is set up to be able to calculate exception reports, which will highlight any unusual power usage, such as negative reads.

We further recommend that a complete review of the power receivables be undertaken to determine the validity and collectability of the outstanding amount.

(Rating ■)



2.1 Integrity of Power Invoicing Management System (PIMS)(continued)

Management Response

We concur that there are material institutional and operational problems in the Power Authority. The billing system introduced in year 2001 has its associated problems and we are aware that these problems should and need to be addressed. The Government, in association with its development partners, has established a steering committee to look into and address the inherent and multifaceted problems in the Power Authority. The tasks involved will include the PIMS and how to allow the system to produce credible bills and 'exception reports'. We will however convey the audit observation to both the Power Authority management and the Steering Committee.

Audit Conclusion

We are pleased that a steering committee has been formed, we will review the Power Authority situation during our next audit.



2.2 Power Meters

Audit issue

The meter recording worksheets are not effectively indicating which meters are missing or not in operation.

Observation and Effect

We noted cases in which the meter reading has remained the same over several months, without any action taken to verify whether or not the meter was missing or not in operation.

The meter reading worksheet has a space to write in last month's reading as well as the current month's reading. It is apparent that last month's readings are rarely if ever recorded on the worksheets. Because last month's figure is not recorded, there is no immediate indication that the meter has not moved and that it may be broken.

Since domestic and social customers with broken meters are invoiced for only US\$1/ month (the nominal charge for the first 25 kwh), it is possible that they have been undercharged relative to their actual power usage.

We also noted that the technicians and engineers who repair the meters are not able to locate the meters from the map and identification method adopted by the Power Authority.

Recommendation

We recommend that a review of power meters is carried out to ensure that they are functioning correctly. The first step in achieving this will be to ensure that an accurate and easily identifiable map of all meters is developed. This will ensure that not only meter readers, but also technicians and engineers can easily locate meters for repairs and reading.

Last month's meter reading should be recorded next to the current month's reading on the meter worksheet, and where there is no movement these customers should be targeted for meter testing.

(Rating ■■■■)



2.2 Power Meters (Continued)

Management Response

As noted in the preceding response to your observation, the matter will be passed over to the Power Authority management as well as to the Steering Committee for their necessary remedial action.

Audit Conclusion

Refer to schedule 2.1.



2.3 Power Debt Collection

Audit issue

There is currently no formalised debt collection policy for outstanding debtors or a formalised process to allow for disconnection of power on non-payment of invoices.

Observation and Effect

A number of customers have sizeable amounts in arrears from both before and after April 2002. The amount of billing calculated per PIMS to 30 June 2002 was \$18,784,111 whilst the payments collected and banked for power services amounted to \$1,997,483. This suggests that there is approximately \$16 million of uncollected power revenue, however as mentioned in point 2.1 the validity of the \$18,784,111 is in doubt. We were unable to verify the balance of outstanding power invoices.

The PIMS system does not produce an aged report of outstanding power invoices, so it is not possible to easily determine how long debtors have been outstanding. Furthermore it appears that the staffing numbers at the Power Authority are not adequate, as an example there is no staff members dedicated to debt collection.

Recommendation

A formalised debt collection policy will ensure that payments are received on a regular basis whilst also identifying and limiting potential bad debts. Invoices should be amended so customers are aware that any breaches may result in disconnection of the power supply.

We would also recommend that a review of the staffing structure be undertaken to determine the positions required and the training needs for the Power Authority to operate effectively and efficiently.

(Rating)

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2.3 Power Debt Collection (Continued)

Management Response

This observation is pertinent. Again, as mentioned in preceding responses to your observations, the Power Authority Management and the Steering Committee will accord the subject adequate priority.

Audit Conclusion

Refer to schedule 2.1.



2.4 Power Billing

Audit issue

Domestic bills issued for 3 months at a time rather than one month may be incorrectly calculated.

Observation and Effect

Domestic customers are billed \$1 per month for the first 25kwh used, it was noted during our review that the PIMS system was not calculating the usage correctly when a domestic customer was being billed for more than one months usage; i.e. where the customer was billed for three months power charges the system is calculating the charge as \$1 for the first 75kwh, whereas the charge should be \$3.

As a result, the invoice amount is understated in these cases.

Recommendation

It is recommended that the invoice programming of the PIMS system is reviewed and the parameters are adjusted to ensure that the correct usage charges are being calculated.

(Rating ■■■)

Management Response

We agree with your observations and they will be brought to the attention of all those concerned within the Power Authority for their priority action.

Audit Conclusion

Refer to schedule 2.1.



3. Asset Register

Audit Issue

The full listing of assets has not been completed and no complete physical verification of the assets of the Government was undertaken during the year.

Observation and Effect

The following issues were identified in regards to assets held by the Government:

- The detailed listing of assets has not been completed to include all assets purchased or donated to the Government;
- Land and Buildings and infrastructure assets have not been recorded or valued;
- The detailed listing of assets is maintained on an Excel spreadsheet;
- Our audit of the available listing highlighted a number of errors in either the description, serial number, cost or location of the assets;
- Most Government agencies have prepared detailed listings of assets, however these listings have not been reconciled to actual purchases of assets for the year;
- Individual agency asset listings have not been crosschecked to the full listing of assets;
- No regular check/count of assets had occurred; and
- No depreciation has been charged against the assets.

If assets are not recorded on a detailed asset register and identified by way of an asset number the risk of assets disappearing increases. Furthermore if the Government adopts accrual accounting it will prove to be a very time consuming task to compile a detailed listing of all assets.

We understand that you are in the process of finalising the asset register and when the register is completed the details will be downloaded into Freebalance asset module.



3. Asset Register (Continued)

Recommendation

We recommend that a full physical verification of all assets be undertaken prior to the listing being downloaded into Freebalance. Asset registers should be maintained for all agencies and regular counts of assets should be undertaken to ensure that the asset still exists and is in good working order.

We would further recommend that additions to the asset register be reconciled to the capital expense at least annually, to ensure that all assets purchased during the year are recorded in the asset register.

In addition the Government should develop a policy in relation to assets, this policy should at a minimum include the following:

- depreciation rates for classes of assets;
- setting of a threshold for assets to be capitalised;
- attractive and portable assets below the capitalisation threshold, which need to be accounted; and
- valuation requirements.

(Rating ■■■)

Management response

We have a complete and referenced listing of all assets transferred by UNTAET to the government. This information was supplied to you, including their locations. It was in respect of some of the Government procured assets, particularly dating as far back as UNTAET Trust Fund days, which the Inventory and Assets Unit is currently identifying their locations and referencing them with bar codes. You will appreciate that over 80 per cent of about 12,000 individual asset items have been fully costed, referenced by bar code numbers and their locations identified. The exercise of completing the inventory listing is expected to be completed in October 2002 for eventual import of the necessary data in the newly acquired Freebalance Assets module. The staff have all been trained on the use of the module, and very soon we will have an updated and credible assets register.



3. Asset Register (Continued)

Management Response (Continued)

Agencies are being encouraged to maintain their individual register. As soon as the referencing and valuation of government-acquired assets is complete, there will be a full and complete verification and reconciliation with individual agencies' registers. The Inventory Control and Asset Management Unit will assist the agencies to maintain their own registers in a standardised manner.

As regards the depreciation policies and thresholds for determining assets held for 'accountability' and 'stewardship' basis, these have already been derived and are configured in the 'Freebalance Assets Module'. The policy on depreciation will become useful, as you know, when Timor-Leste migrates to an accrual basis of reporting and not before.

Audit Conclusion

We will review at next audit.



4. Revenue Retention Agencies

Audit Issue

Revenue retention agencies are not preparing accrual financial statements and are not being separately audited.

Observation and Effect

There are three agencies within the Government of the Democratic Republic of Timor Leste, these being; Power, Port and Aviation which raise their own revenue. These agencies expenses (except for the Power Authority) are not funded through the consolidated fund but rather from their own revenue. Under regulation 2001/13 Autonomous public authorities should keep their own accounting records in accordance with International Accounting Standards, i.e. full accrual accounting should be adopted and the financial statements should be independently audited. No separate audits have been undertaken for these agencies.

Currently the revenue and expenditure for these agencies is being consolidated into the Consolidated Fund of East Timor on a modified cash basis. Under the modified cash basis adopted by the Government it is difficult to determine the profitability of each of these agencies. The modified cash basis does not take into account receivables, capitalisation of assets, depreciation of assets and other accrual type accounting entries.

As these agencies do not prepare accrual financial statements it is difficult to determine whether the Government is incurring losses or making profits from the operations of each agency.

Recommendation

We would recommend that all revenue retention agencies adopt full accrual accounting in order for the Government to be able to accurately assess their operations and to determine their profitability.

We would further recommend that these agencies are separately audited to ensure good corporate governance.

(Rating ■■■)



4. Revenue Retention Agencies (Continued)

Management response

As you would glean from the accounting policies and the notes to the accounts particularly relating to the Revenue Retention Agencies, it has been said that the institutional arrangements foreseen in the cited Regulation to allow for these agencies to be self-accounting, distinct and autonomous institutions, have not been in place. To allow these agencies to prepare their own accounts based on full accrual system would require major structural, administrative and institutional changes which, in this short period of time, could not be achieved. However, we have prepared the accounts based both on cash basis and modified cash basis to inform on the minimum profitability levels of these agencies based on the principle of absolute conservatism. The conservatism principle applied, as the accounting policies dictate, recognises only those revenues that have been invoiced and paid for. However, all expenditures, either paid or committed, have been accounted as expenditures for the purpose of assessing individual agency profitability.

We could, for the next fiscal year accounts (2002/03), experiment the production of the final accounts on the basis of a full accrual system particularly for Aviation and Ports whereby the only additional information required for generation would be the invoiced amounts accrued as at the end of the fiscal year. Such accounts could be separately audited and subsequently consolidated in the whole-of-government accounts notwithstanding that the institutional and other arrangements may still not have been in place for self-accounting purposes. The Treasury will and can support the agencies, at least in the short run, in producing the required information in order to allow for the preparation of more informative accounts. The agencies will from this fiscal year be requested to maintain and submit to the Treasury at the close of each month, a listing of all outstanding invoices for purposes of income recognition.

Audit Conclusion

We support your comments to prepare financials on a full accrual basis for Aviation and Port Authority for the financial year ending 30 June 2003.



5. Interest Revenue Timor Gap Royalties

Audit issue

Timor Gap royalty monies held are receiving minimal interest revenue.

Observation and Effect

There is a significant sum of monies held for Timor Gap royalties which have earned a minimal amount of interest in the year ending 30 June 2002.

These monies could be earning a significantly higher amount of revenue if they were invested in a higher yielding account.

Recommendation

We would recommend that the Timor Gap royalty monies are invested in a higher interest yielding account.

(Rating ■■■)

Management Response

This subject has been an issue occupying our minds over the past months. As you are aware, the cash flow situation of the Transitional Administration as well as the Government was rather unpredictable with donors pledged funds being received at irregular intervals. The policy to create national savings of the Timor Gap Royalties was unclear amidst the pressures on the liquidity situation in the funding of the Consolidated Budget. Now that the policy is clear, and also because of the financing arrangements put in place to fund the funding gap recognise the timing constraints, we would be instructing the Banking and Payments Authority to invest the funds in some form of gilt-edged securities to enhance the interest income thereon.

Audit Conclusion

Satisfactory, we will review at next audit.



6. Revenue Reconciliation

Audit Issue

Monies collected and recorded as revenue by treasury are not reconciled by the revenue collecting agencies to the invoices owed by customers.

Observation and Effect

Monies owing to the revenue collecting agencies are deposited and recorded as revenue by Treasury. These amounts are then sent to the agencies and the agencies agree that these amounts have been received but do not reconcile the amount the customer actually owes to the agency.

By not performing regular reconciliations between revenue collecting agencies receipts and receipts to treasury, the risk of errors, such as errors in the manual inputting of revenue may go unnoticed and thus the debtor collections may be based on incorrect amounts.

Recommendation

Monthly reconciliations need to be performed between what has been received into the Banking and Payments Authority and what has been calculated as having to be paid by the revenue collection agencies.

(Rating ■■■)

Management response

As you rightly mentioned, the Treasury produces monthly revenue statements and submits them to the individual revenue earning departments for verification and reconciliation. The onus of reconciling these statements is on the respective agencies some of which have yet to develop the culture of reconciling their figures with those of ours. We have always emphasised the need for reconciliations and, just recently, some agencies have taken the lead to reconcile their monthly statements. Because of the capacity building constraints in a number of revenue generating agencies, this problem of inadequate reconciliation will, for the time being, persist. However we are doing everything possible to impress on the agencies the need for such reconciliations.

Audit Conclusion

We will follow up at next audit.



7. Insurance

Audit Issue

There is no insurance on any capital items.

Observation and Effect

We noted that capital items such as the motor vehicles, buildings, computers and office equipment, etc. do not have insurance. Without insurance it exposes the organization to unnecessary financial risks.

Recommendation

All capital items should have insurance for loss, theft, fire, and other destruction.

(Rating ■■■)

Management Response

You are right that the government has no insurance coverage on its assets. This includes even motor vehicles, which were insured only up to end of fiscal year 2000/01. The policy of insurance is under scrutiny by the Office of Procurement and Inventory Management and Supplies. Meanwhile, it may be inferred that the government is self-insuring its assets.

Audit Conclusion

We will follow up on policy at next audit.



8. Procurement

Audit Issue

The relationship from the purchase orders to the commitment payment vouchers (cpv) is not easily identifiable.

Observation and Effect

When reviewing purchase orders it was difficult to determine the linkage between the purchase orders and the authorised cpv. The Procurement unit had difficulties finding purchase orders based on the cpv number. There were also difficulties in determining where the purchase orders were filed or which staff was responsible for the purchase orders.

Without a proper linkage between the cpv and the purchase order there were inconsistencies when trying to review the amounts outstanding on the creditors listing. Both management in procurement and treasury may have a difficult time determining when the cpv has been fully committed. Also, suppliers may have difficulty with procurement in trying to query the order if the department is unclear where the purchase order is filed or who is responsible.

Recommendation

We are aware that Freebalance now has the capability of raising the purchase order against the cpv. This would allow for a direct linkage between the two documents and would allow for much greater ease in reviewing commitments outstanding.

We would further recommend that the Procurement unit develop a procedure whereby all purchase orders raised can be traced and that the staff responsible for purchase orders can be identified.

(Rating)

Management Response

Procurement is reorganising its systems and procedures to link, at all times, the CPVs with their corresponding Purchase orders. With the Freebalance Procurement Module currently being implemented, this apparent problem as well as document mis-filings should not arise.

Audit Conclusion

We will review at next audit.



9. Payroll

Audit Issue

The following two issues are noted for payroll:

1. Payroll has been processed without proper authorisation from District Agencies.
2. Payroll amounts which have been redeposited in the bank have not been recorded in the ledger on a timely basis.

Observation and Effect

1. A payroll report (POSA) Payment of Salary Advice is generated for each agency within the districts. The POSA report is sent out to the district agencies for checking and approval (normally 2-3 days before). The district agencies will advise Dili as to whether they agree or not with the pay run. If advise from the district is not received by the Payroll unit in Dili within the agreed upon timeframe the pays are processed and the cash is sent to the District. This has resulted in a large number of pays being returned to Dili, as employees have not collected their salary. The non-collection in some cases may be due to the employees relocating, however it was noted that a number of non collections were due to the fact that the employees had not worked during the relevant pay period.

Without proper review from the district agencies of the monthly payroll run, errors in payroll could go undetected, also additional costs are being incurred as pays are being calculated, cash is collected from the bank sent to the districts and then returned to Dili for rebanking. There is also the added risk that cash may not be returned to Dili.

2. As explained above in Note 1, when cash is given out to the agencies for payroll expense and some of the amounts are returned and redeposited in the bank, the entries to record these amounts as a credit to the appropriate agencies has not been done until the end of year.

Since the entry for the reduction in payroll was not done until the end of the year, the monthly analysis of these accounts compared to budget appropriations and actual expenditure would have been distorted.



9. Payroll (Continued)

Recommendation

Prior to the processing of the monthly payroll the government should ensure that all POSA report have been approved by the District Officers. We would recommend that this procedure be strongly enforced upon the District Officers to reduce the risk of cash being mislaid or misappropriated.

The payroll redeposit ledger entries should be recorded on a monthly basis.

(Rating )

Management Response

You have acknowledged that the individual District Payrolls, when prepared by the payroll Unit of the Treasury are sent to District Administrations for verification and confirmation within a give time frame. The same procedure operates for Dili-based agencies. In the absence of a reaction from the District as to any errors in the personnel listings and emoluments, it was concluded that the listings as submitted were credible. This has not been the general rule and only very few districts are affected. In the immediate term, we do not intend to create disruptions in the timely payment of salaries to the district staff. The problem is associated more with capacity constraints at district levels since the contracts of 12 international District Finance Officers (UNVs) had lapsed since April 2002.

We do agree that we must enforce timely submission of returns from the districts to allow for accurate payroll listings and thus avoid the potential of misappropriations.

Audit Conclusion

We note your comments and acknowledge that human resources is an issue for East Timor. However, we do recommend that a review of the controls of the payroll process be undertaken.



10. Unallocated Stock

Audit Issue

The following two issues are noted for unallocated stock:

1. The final stock listing at 30 June 2002 was not reconciled to the stock ledger balance in Freebalance.
2. Cut-off procedures for stock count.

Observation and Effect

1. The final unallocated stores stock listing amounts to \$1,183,707 whilst the ledger balance in Freebalance is \$1,292,000, a variance of \$108,293.

An ineffective perpetual inventory system may cause management to incorrectly manage stock levels, i.e. inadequate stock levels or oversupply of stock. Furthermore, management is unable to determine whether stock has been misappropriated or simply unaccounted for at another location.

2. An order for chairs with a value of \$31,305 was ordered and received before the 30 June 2002 but was not included in the stock count listing at that date. These items were added to the final stock listing.

All deliveries need to be included on the stock listing before the cut off of 30 June, if this is not completed it is possible that there will be material errors which may go undetected.

Recommendation

Review the perpetual inventory system to ensure it is functioning effectively and perform regular stock counts. The results of the stock counts should be reconciled to the balance in Freebalance in a timely manner.

All items that are delivered before the cut-off should be included on the stock count listing at that date.

(Rating)



10. Unallocated Stock (Continued)

Management Response

The maintenance of adequate stock records at the Unallocated Stores has been an issue addressed with the Inventory Management Unit. We have recently acquired an inventory management software, installed and implemented it to allow for accurate reporting of stock movements. The staff had been given training in Darwin in the use of the software. As from this fiscal year, a perpetual inventory management system has been put in place. Without this system, and with the high volume of stock movements during any single year, a systematic reconciliation would be impossible. Reconciliations were done but in a less than systematic manner.

The difference between Freebalance stock value balance and the valuation based on the stock count at year end could be attributable more with valuation errors than any misappropriation of stocks. This sort of difference is always likely to occur in the absence of an inventory management software.

On the subject of recording cut-off stock movements, we have noted your observation for implementation.

Audit Conclusion

We will review at next audit.



11. Bank Reconciliations

Audit issue

The following issues were noted in relation to the Bank Reconciliations:

1. The ledger balance of the bank accounts for the Maritime Port Authority and Banking Payments and Authority have not been updated and agreed to the reconciliation amount.

No bank reconciliation has been prepared for the Power Service Authority.

2. There are a large amount of unrepresented payments in the BPA bank reconciliation.

Observation and Effect

1. The following bank reconciliations do not balance to the ledger as summarised in the table below:

Bank Account	Ledger Balance	Reconciliation Balance	Variance
	\$(000)	\$(000)	\$(000)
BPA	11,306	11,211	95
Power	37	0	37
Maritime Port	1,189	1,182	7

2. The bank reconciliation for the BPA account includes \$941,000 of unrepresented payments. This amount includes outstanding payments dating back from July 2001, it was also noted that a number of these cheques appear to have been cancelled or not collected.

Misinformation of the balance for the bank may lead to inappropriate decision-making.



11. Bank Reconciliations (Continued)

Recommendation

We would recommend that all bank accounts are reconciled monthly and that the ledger balances for all bank accounts are updated according to the reconciliation balance.

We further recommend a review of the unrepresented payments on the main bank account be undertaken and any adjustments necessary are recorded.

(Rating )

Management Response

The reconciling items in these bank accounts are the usual items 'in-transit' that existed at the end of the fiscal year. Information for the updating of the accounts was ready and available at the time of audit, and the entries for the same were ready for updating.

Upon discussion and presentation of these items for updating to the audit team, it was decided that they did not present a material amount for inclusion in the accounts. They were to be posted into the current fiscal year.

We have always carried out reconciliations and posted adjustments items on a monthly basis. The few items that were outstanding in the reconciliation as at 30th June 2002 were properly explained in the reconciliation and the appropriate entries made to rectify the situation.

Power Service Authority account in the General Ledger agrees completely with the BNU bank account. This is shown in your table above.

As at now, full reconciliations for the months of July and August 2002, have been completed and all reconciling items have been posted.

The differences shown in your table above are only the net effects of the reconciling items in the bank reconciliations. These items when posted will bring the bank reconciliations in line with the account balances. As at now, they have all been posted. This is, in essence, the main purpose of the reconciliation exercise.



11. Bank Reconciliations (Continued)

The long outstanding cheques mentioned in your observation are very few and have no substantial effect on the balances. It is normal to review each of these items and decide the action to be taken. Cancelled cheques, or the double-posted item, are being reversed to bring our cash book balance more in line with the BPA Bank Statement. Most of the unrepresented cheques have been presented in July and August and reflected in the accounts accordingly. We are liaising again with the agencies to alert their customers to collect those cheques which have yet to be collected.

There is no risk of misinformation arising from outstanding unrepresented cheques as they are all known and represent authentic payments for services rendered. In any case, their delayed presentation only positively affects our liquidity standing. We do not rely on the bank statement for the purpose of ascertaining our true liquidity balance but mainly on our cash book as reconciled with the bank statement.

Audit Conclusion

We acknowledge your comments, however, the listing of outstanding payments provided to us during our audit disclosed a number of items that appear to be reconciling items not authentic cheque payments. We will review the bank reconciliations at our next audit.



12. Bilateral Fund Agreements

Audit Issue

Formal Agreements have not been received for all bilateral funds.

Observation and Effect

Numerous bilateral funds between the government and donors do not have formal agreements in place. In many cases monies are deposited in a bank account with no documentation from the donor of their intention of the funds.

Without formal agreements in place disputes may arise on how monies were to be expended.

Recommendation

Agreements between the government and donors should be documented and filed at Treasury.

(Rating)

Management Response

It is true that some bilateral donations there have not been any formal agreements between the beneficiary agencies and the donors. As explained last year, some donors have chosen to support short-term programmes of agencies, outside the formal budgeting process, by simply drawing a cheque payable to the government account. Invariably, the agencies have been requesting Treasury to establish sub-accounts to receive donations from particular donors who intend to contribute to the accomplishment of certain government functions. An example of this is the Independence Celebration Special Account. Donors simply paid in some monies into the account based on solicitations by the Independence Committee to fund Independence Day activities. No formal agreements have been entered into.

Notwithstanding, we agree that, under normal circumstances, formal agreements should have been put in place, denoting the specific purpose(s) of the donation. This has been done for some larger donations.

Audit Conclusion

We will review at next audit.



13. Internal Audit Function and Strategic Audit Plan

Audit Issue

No Strategic Audit Plan has been developed for the internal audit of Government.

Observation and Effect

The internal audit function has developed an internal audit plan for the 2002/03 financial year, however it appears that the plan has been based on an adhoc basis of reviews of certain agencies, rather than a strategic risk based internal audit assessment.

By not having a strategic risk based internal audit plan, internal audit resources may not be utilised in the areas considered to be of high importance.

Recommendation

A strategic audit plan should be established for each agency and incorporated into an overall audit plan for the whole of Government. The strategic audit plan should document the high-risk areas for each agency and these areas should be targeted for internal audit as a matter of priority. The internal audit function should also undertake compliance audits, however high risk areas should be reviewed to ensure that all risks of the Government are being identified and that adequate controls to mitigate the risks are in place.

(Rating)



13. Internal Audit Function and Strategic Audit Plan (Continued)

Management response

We note your concerns on the issue of a strategic internal audit plan. However, the internal audit plan prepared for 2002/03 is, in actual fact, based on what are considered as the strategic risk areas of government. You are aware of the existing capacity constraints of the Internal Audit. The Unit will nonetheless be directed to devote more of their time and resources to those defined risk areas in order to recommend improved internal controls. The Unit's staff have been requested to update their familiarity with established procedures and good practice in order to reinforce their capacity to undertake more compliance audit work.

Audit Conclusion

We acknowledge the Internal Audit department is still in the process of being developed and was set up to assist Treasury with ensuring that controls are in place and working effectively.



14. Land and Property Debtors

Audit Issue

There is currently no formalised debt collection policy in place for rental debtors and no power to evict tenants.

Observation and Effect

A number of tenants have sizeable amounts in arrears and have since left the country. Without a formalised plan for addressing debt collection, the amount of debtors turning bad may increase.

There are also a number of tenants who are currently in arrears and cannot be evicted unless they are taken through the court system. This process is extremely slow and would mean that tenants, especially foreign tenants would have sufficient time to leave the country before their case is heard in court.

Recommendation

A formalised debt collection policy will ensure that rent is received on a regular basis whilst also identifying and limiting potential bad debts. Contracts with tenants should be amended so tenants are aware that any breaches may result in an immediate eviction.

(Rating)

Management Response

The only agreements in place for tenants occupying state properties are the individual agreements signed between the District Administrators/Land and Property Unit with the individual tenants. We have assigned an international finance officer up to 31 March 2002, supported by one other Timorese Finance Officer to carry out the function of rental debt monitoring and collection. You are right that with the slow pace of the litigation system and the difficulty associated with enforcing eviction of tenants, some tenants may actually leave the country without paying their arrears.



14. Land and Property Debtors (Continued)

Management Response (Continued)

We will advise the District Administrations as well as the office responsible for Land and Property administration to develop a formal enforcement policy for debt collection.

We have quarterly reports of all rents due, paid, and in arrears supplied by the District Finance Officers. Such information can be a useful starting point to draw up formal policies and take necessary legal action. The latest report indicates however that only 60.1% of collectible rents was actually collected. A sum of \$444,656 remained uncollected from the overall collectibles as at 30 June 2002. This is significant and we would relate to the revenue generating agencies involved to put in the measures to collect these arrears.

Audit Conclusion

We will review at next audit.



15. Business Continuity Plan

Audit Issue

There is no documented disaster recovery or business continuity plan for the government that addresses the ability to recover critical IT systems or key business processes in the event of a significant disruption.

Observation and Effect

In the absence of a detailed business continuity plan, there is a risk that, whilst computer systems may be recovered after an incident or crisis, the business may find that it is unable to operate at a sufficient level during or after the disruption. This may arise if, for example, business personnel unexpectedly cannot gain access to their usual place of work, or paper documents have been damaged.

Recommendation

A business continuity plan documents the procedures that will be put in place to enable the business to continue operating in the event of, for example, the loss of computer support facilities, power failure or fire in the computer room.

We recommend that management consider developing a business continuity plan covering the critical operations of the government. This is likely to entail each area of the business carrying out an assessment of the criticality of each of its processes, and deciding how quickly it would need them to be re-established after a serious incident.

For the priority processes, the business area should identify what it would require to recover the service, e.g., staff, documents, space, power and IT services, and draw up plans to deliver these requirements. The IT requirements should be passed to the IT department, which would compile an overall plan for the IT aspects, showing prioritised hardware, communications, back-up needs and so on.

The plan should be updated and tested as far as possible on a regular basis (for example, a plan may fail if there is a serious problem at night, and a key individual cannot be contacted because their phone number was not updated when they moved). It is particularly important to ensure that changes to IT systems are incorporated into the plan.

(Rating)



15. Business Continuity Plan (Continued)

Management response

Your observations are noted. We have now got a complete back-up server system for both Freebalance FMIS and CHRIS Payroll. We used to rely on one server which, as you rightly pointed out in general, cannot assure business continuity should a catastrophe happen. We will however engage the IT Unit in the ministry of Planning and Finance (a unit which has been strengthened recently) to re-examine our existing business continuity plan and update the plan to mitigate the potential risks. Already, we have archived our prior year financial documents in a secure room at a separate location from our existing office premises. Again, we have backed-up our financial data relating to the current and previous years in a second server unit.

Audit Conclusion

We will review at next audit.